new entrants. The LECs can essentially flip a switch and be in the long distance business throughout their region. Outside their home territory, they can choose from among at least four nationwide long distance networks to purchase facilities for resale. Effective policies for resale of both retail services and unbundled network elements ensures that the first stop in one-stop shopping for telephone service is equally available to all competitors.

From the point of view of getting competition into the residential market, it is the indispensable first step to achieving the Commission's goal of facilities-based competition in the long term. It must also be recognized that in the long term there may be significant market segments which will not support multiple sets of facilities. A pro-competitive, unbundling and resale policy must play a major part in providing competition in these areas on a permanent, long-term basis.

CFA and CU agree with the FCC's tentative conclusion at para. 196-197 of the Notice that for an unbundled resale tariff to promote competitive entry, it must not be laden with unnecessary restrictions and conditions and or priced so unfairly that it will be impossible for competitors to do business through resale of wholesale services. As mentioned above, the only fundamental restriction should be against selling services across customer classes. That is, those who buy residential services at wholesale should be required to sell those services only to residential customers. This restriction can be implemented by an auditing approach or through carrier complaints. Such a policy avoids undercutting the ability of the competitor to use the tariff, or placing unnecessary barriers in the way of those who wish to use this tariff. The total wholesale resale tariff should carry with it all the protections that the retail service entails. This includes meeting quality standards, non-discrimination and consumer protection.

In addition to proper pricing of network elements and LEC services, number portability and dialing parity which ensures competitively neutral number assignment and portability across services, geographic areas and providers (true number portability), must be implemented without creating differences in quality or cost for competitors. Indications are that consumers are far less willing to switch their carrier if they must switch their telephone number as well. On these points, we support the tentative conclusion of the FCC at para. 211, 214 and 215 of the Notice.

As this section underscores, CFA and CU believes the underpinning of success of this legislation depends on the ability of competitors to enter the local market through a variety of ways. Decisions about market entry will ultimately come down to a question of price. We shall now turn to this most fundamental issue.

III

THE PROBLEM OF PRICING TO PROTECT CAPTIVE RATEPAYERS IN A MULTI-PRODUCT, MIXED COMPETITIVE/MONOPOLY ENVIRONMENT

A. THE IMPORTANCE OF HISTORY: THE ECONOMIC VALUE OF THE LOCAL MONOPOLY

In choosing a cost standard, the FCC must not underestimate the impact of decades of franchise monopoly status. As previously stated, this monopoly in local telecommunications services has resulted in a large number of factors that prevent competitors from entering the local telephone market. These range from legal prohibitions, to economic obstacles, to public policy barriers. This protected monopoly history has an immense impact on economic structures on a going-forward basis.

Just like the farmer who inherits the most fertile land at the mouth of the delta of a river, the local telephone companies have inherited their position. The farmer reaps the windfall of lower cost (e.g. no need to irrigate, less need to fertilize and lower transportation costs) as a right of ownership. The ground rents associated with public utility rights of way, however, properly belong to the public. The FCC must not allow incumbents to capture these ground rents as excess profits in the transition to a multi-product, competitive firm. Most importantly, these rents must not be allowed to confer a cost advantage on the incumbents, enabling them to frustrate competition.

The local exchange company serves markets which cover a much broader range of demand elasticities than those of any potential entrant. No potential entrant possesses a core market with anything near the extremely low elasticity of demand of residential telephone service, to which the vast majority of the incumbent's shared (joint and common) costs can be

allocated. As a result, if permitted, the local companies can strategically allocate costs to frustrate competition. New entrants whose incremental costs are lower for specific services could be prevented from entering the marketplace because the incumbent is strategically allocating shared costs (joint and common costs) to prevent that entry. By treating the less competitive residential sector as a core from which a disproportionately large portion of shared costs (including loop as Congress intended) are recovered, the company can then price its competitive services below their total service long run incremental costs (TSLRIC), forestalling entry of competitors.

B. THE POTENTIAL FOR CROSS-SUBSIDY AND ANTI-COMPETITIVE PRICING

1. Cross Subsidy and Other Cost Advantages

The presence of sunk costs and the failure to properly deal with future efficiencies creates a serious risk of anti-consumer, anti-competitive pricing. The potential for massive cross-subsidy in the integrated telecommunications firms should not be underestimated. CFA and CU believe recognition of the depth of the potential problems of cross-subsidy is the key to enacting pricing policies which will lead to effective local competition. The local exchange companies intend to build a high capacity network which will commingle hardware (facilities) and software (expertise and resources) between monopoly and competitive services spanning a number of sectors within the industry including local and long distance telephone and video at a minimum.

That there will be shared costs (joint and common costs) is inevitable. The expertise to be shared would include facilities, personnel and software for routing traffic, billing, operations support systems including traffic management, planning, and engineering, to name just a few

functions. Many of these managerial functions could be performed on a centralized basis. Indeed, we have witnessed a strong trend in the industry toward centralizing functions. Initial and ongoing transactions between regulated and unregulated, telco and non-telco components of the companies will abound.

Moreover, the problem of protecting the public and competition goes far beyond the issue of cross-subsidy. There are vast cost advantages that the franchise monopolist enjoys as a result of adding new businesses to its core monopoly. The existence of these cost advantages raises a fundamental question of whether stockholders or ratepayers have a claim on them and how they will impact on the competitive marketplace.

If facilities have been or are being paid for by ratepayers, then ratepayers have a claim on them. For example, fiber optic trunks and loops now being deployed by local exchange companies are vastly under utilized. That excess capacity, which is being paid for by ratepayers, will be used to provide dialtone, data transmission, video and other services. Astonishingly, some LECs have asserted that *none* of the costs of fiber should be attributed to services other than dialtone. This flies in the face of the principle that those who reap the benefits should pay the costs

Moreover, competitors of the LECs do not have access to such "free" facilities since they lack captive ratepayers. Hence, they would immediately be placed at a competitive disadvantage. The FCC surely would not want to permit overcharging of captive ratepayers to facilitate entry into other businesses. Indeed, we believe such a policy would be illegal under

the 1996 Act.[13] Perhaps the clearest statement of this anti-competitive approach to deploying an advanced network was made in internal BellSouth papers.[14] This document described how the costs of delivering competitive services would be shifted onto telephone ratepayers by recovering all the joint and common costs from telephony.

> This offers [1] the opportunity to cover the fixed costs of providing fibre to the home with POTS revenue and selling CATV transport to overbuilder, entrenched CATV operator and pay service vendor (HBO, etc.) alike at probably market prices well in excess of incremental costs. At that time, [2] profit or rate-of-return regulation should have evolved to price regulation either by the current set of state and federal regulators or by the market itself. [3] This means BellSouth will be able to keep its CATV transport profits despite the relative low level of incremental cost required to provide the service.
>
> Having become "The Guy Who Got Fiber To the Home First", BellSouth's ubiquitous CATV transport will provide the "critical mass" necessary to support transport of the entire spectrum of BISDN services provided by the ESPs [Enhanced Service Providers]. Given the relative low incremental cost of "mining" more of fiber's huge bandwidth capacity to transport the wide variety of BISDN services and the pent-up demand signaled by the McKinsey study, BellSouth's BOCs' profit potential appears good.

In this case, competitive services may cover their incremental costs, which means that the minimum cross-subsidy prevention standard may be met, but it does not adequately protect consumers, because they receive none of the benefits of the utilization of excess capacity for which they are paying. It does not adequately protect competitors because they are placed at

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[13] §254(k). "Subsidy of Competitive Services Prohibited.--A telecommunications carrier may not use services that are not competitive to subsidize services that are subject to competition. The Commission, with respect to interstate services, and the States, with respect to intrastate services, shall establish any necessary cost allocation rules, accounting safeguards, and guidelines to ensure that services included in the definition of universal service bear no more than a reasonable share of the joint and common costs of facilities used to provide those services."

[14] Memo from R.T. Burns Assistant Vice President to N. C. Baker, Senior Vice President on "CATV Transport: Catalyst for BISDN", BellSouth Services, June 14, 1988, p. 10.

a cost disadvantage which has its origins in the monopoly franchise, not the competitive marketplace.

In the example given above, there may or may not technically be a cross-subsidy; the line is difficult to draw. If the cost of the excess capacity could have been avoided, then there is a cross-subsidy (telephone subscribers are paying more than the least cost, stand- alone service costs of a well-engineered network). If excess capacity could not have been avoided, due to the fact that capital is lumpy and the excess capacity occurred in the pursuit of the least cost technology, there may be no pure economic cross-subsidy. In either case, however, the consumers who paid for the network investments through general rates should share in the benefits of increased revenues that will be generated in the form of reduced future rates for local service.

2. Economic Coercion

Even if no technical cross-subsidy exists, there is still a serious problem of economic coercion -- ratepayers receiving no benefits from economies of scale and scope, even though they bear costs, and competitors placed at an unfair disadvantage because they have no access to those economies. Proper cost and price analysis is essential in order to prevent these problems and get to competition.

Current cost allocators do not capture the cost causal nature of the deployment of a radically different technology. Because competitive services and advanced functionalities are the drivers on the information superhighway, these allocators will certainly underestimate the share of costs that should be imputed to competitive services.

Suppose that, on a cost causative basis, the cost of functionality should be split 4:1

between competitive and utility services. For example, suppose a broadband network requires five times as many remote distribution units as a narrowband network. Suppose that the expense allocator is only 2:1. A competitor who must deploy four remote distribution units to deliver broadband network service will confront the telephone company, which has attributed the cost of only 2.5 remote units to its broadband services. The competitor will be at a disadvantage compared to the incumbent who has shifted costs onto captive ratepayers.

As long as there are joint and common costs with some lines of business above the line (regulated) and others below it (unregulated), there is always an incentive to put costs above the line and profits below, particularly in the period leading up to the setting of the price cap. In addition, price cap regulation does not alter this incentive for services which are not subject to the cap. It may increase its overall profits by shifting some costs to the monopoly side in order to achieve a higher market share and higher profits in the unregulated lines of business.

Nor does the local exchange company need to recover costs shifted onto utility ratepayers on a going-forward basis to achieve a competitive advantage. If the allocation of sunk costs does not reflect proper cost causation, the damage will have been done. Price caps do not eliminate this incentive either. To the extent that the regulator fails to properly pull costs into the competitive jurisdiction, the productivity performance of the utility operations will be artificially depressed. Productivity adjustments will be too low and monopoly local rates will be higher than they should be.

Even on a going-forward basis, price caps do not adequately promote competition or protect consumers where shared costs are large. Potential cost savings that result from the integration of utility and competitive services have not been reflected in the productivity gains

in the past. To the extent that future productivity offsets do not reflect the gains uniquely associated with additional economies of scale and scope on the integrated network, this is a windfall to the incumbent local exchange carrier.

Congress recognized the important problem of economic coercion and adopted clear language to prevent it in Section 254(k). Basic service can bear, at most, a reasonable share of joint and common costs.

IV

A PROPOSED METHODOLOGY

The preceding critique of current allocators and potential anti-competitive behavior demonstrates that in order to promote competition and protect captive ratepayers, the FCC must adopt a rigorous methodology for identifying the costs and benefits of the network upgrades. The methodology should be divided into two steps: cost analysis and cost recovery (pricing).

The Commission should adopt specific, operational principles for each step. Cost causation is just a starting point of cost analysis; how to determine cost causation must also be stipulated. While it is easy to say that incremental costs should constitute the price floor, that says little if you do not define what the increment is.

The following sections of our comments address the critical questions raised in §d beginning at page 39 of the Notice, Interconnection, Collocation, and Unbundled Elements. In lieu of answering each question individually, we will present a comprehensive methodology for pricing designed to fairly compensate the incumbent and make local competition a reality for as many consumers as possible.

With respect to **cost analysis** we recommend that:

1) cost causation be analyzed, and be defined by

2) the necessary functionalities and capacities projected on

3) a forward-looking basis for those services which are intended to be offered over the network;

4) incremental costs for all services should be calculated for

5) the long term on

6) a total service basis (TSLRIC);

7) stand-alone costs (SAC) should be calculated on

8) a least cost basis; and

9) costs must be analyzed consistently across all major services using the same cost methodology with individual functionalities or specific capacities having similar costs across services.

With respect to **cost recovery** we recommend that:

10) all users should pay for all functionalities utilized;

11) prices should be subsidy free (above TSLRIC and below Y);

12) prices should be based on predictable rules that allocate shared costs across categories in proportion to a measure of cost or use; and

13) the allocation of shared costs, above all loop costs, should minimize the burden on captive ratepayers as required by Congress in §254(k) of the 1996 Act.

A. COST ANALYSIS

1. Cost Causation

Regulators must engage in cost causal analysis for the multi-product firm selling a mixture of competitive and utility services.

2. Cost Causation defined by the Functionality and Capacity Necessary to provide a Service

In order to identify the costs associated with a use or service, regulators should analyze the functionalities and capacities necessary to provide the services intended to flow from the deployment of an asset.

3. Intended Uses

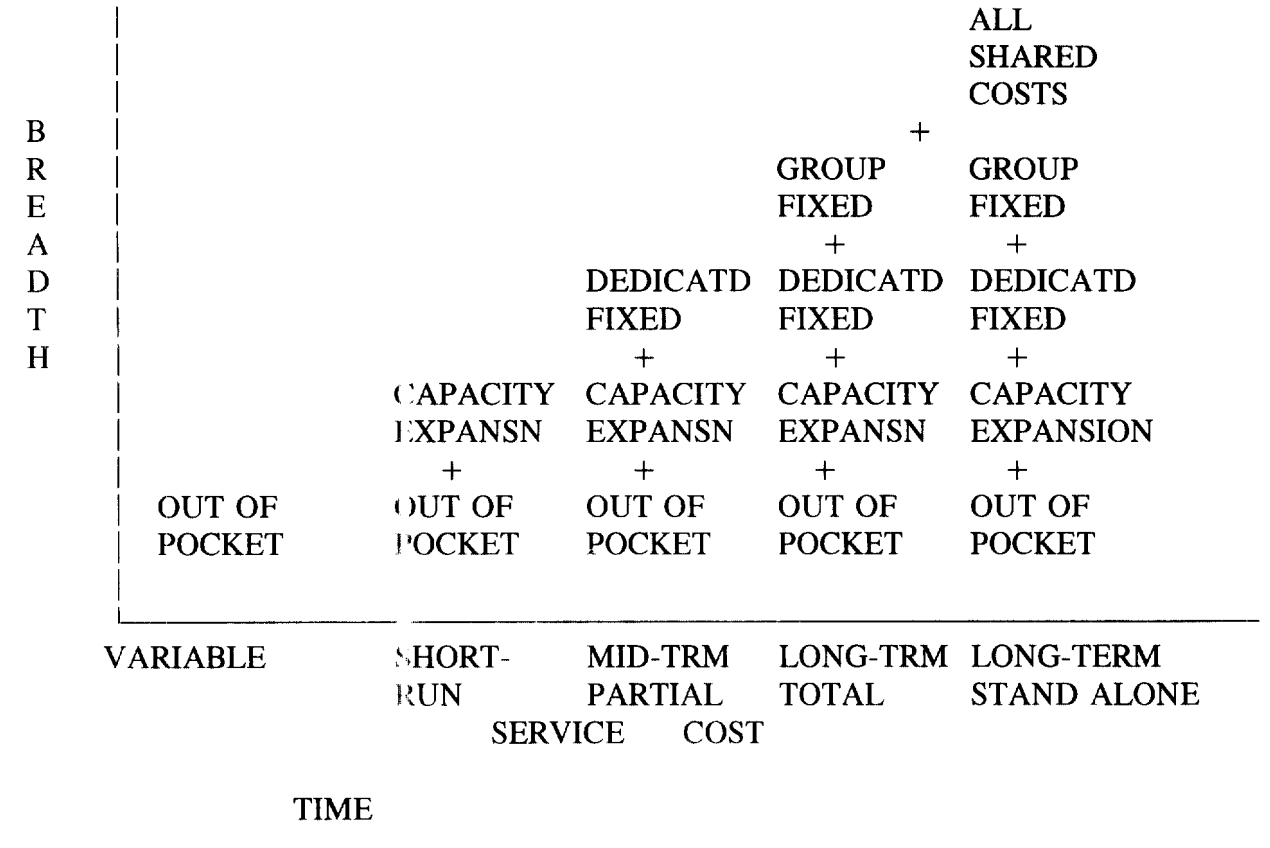
The intended use of assets is also crucial to determining cost causation: For what purposes was the asset deployed? Since most assets have multiple purposes, what specific functionalities were necessary to provide each specific service? Less demanding uses should not be saddled with the costs of higher order functionalities and capacities.

4. Incremental Cost

In order to explain the other recommended principles for cost analysis, it is necessary to examine the debate over incremental cost. Simply stating that prices should be above incremental costs resolves little in the effort to protect consumers and competition, if we do not have a common understanding of what we mean by "incremental cost".

As Figure 1 suggests, defining - not to mention measuring - incremental cost is no simple matter. There are a variety of definitions of incremental cost, each of which may be appropriate for a different regulatory function. The following figure attempts to summarize the different concepts of incremental cost.

FIGURE 1:
DIFFERENT VIEWS OF INCREMENTAL COST



In brief, the concept of incremental cost varies according to the time frame used and the breadth of costs included.

In a competitive industry under stress, short-term out-of-pocket costs are the relevant concept for the firm. They produce and sell as long as prices cover variable costs. This can never be an appropriate basis for long-term analysis, since the firm never covers its fixed costs.

A somewhat longer term view adds small increments of capacity to the out-of-pocket costs, but will not allow new technologies to enter into the calculation. In this approach, current

sunk costs are taken as given. Many telephone company methodologies use this concept.

Some companies include certain dedicated fixed costs in the calculation of incremental costs. This approach does not look forward far enough to make capital costs variable.

Potential competitors, such as MCI in its "building blocks" proposal, include a broader range of costs. I refer to these as "group fixed" costs (defining the precise costs to be included requires empirical analysis). MCI captures more fixed costs in two ways: First, it treats the entire service as incremental in the long term. Second, if functionalities (or costs) are significantly utilized by a service or group of services, they would be captured by total service long run incremental cost (TSLRIC).

Finally, we have stand alone costs. This concept adds in the increments of shared costs which are not captured by the total service incremental cost (TSLRIC) concept. It also is long term, in the sense that it must be the least cost technology.

5. Long Run Costs

Incremental costs for the multi-product, mixed competitive/ regulated firm, should be calculated on a long term basis, where all costs are variable.

In a monopoly context with rate of return regulation in place, it might have been appropriate to use shorter term concepts for designing an incremental cost test to prevent cross-subsidy. There was no competition to be damaged by an unrealistically low floor price and the revenue constraint was effective. Artificially low incremental costs might have had the effect of transferring wealth between classes of customers, but they did not result in excess profits. Since competition was not allowed, they did not cause supply-side inefficiencies (although there may have been demand side inefficiencies).

In the context of emerging competition, with the revenue constraint of rate of return regulation relaxed, these flaws inherent in a short term concept of incremental cost can no longer be tolerated.

6. Total Service Cost

The long term increment to be studied must be total service, since that is variable in the long term. Looking at a small increment of the service would allow pricing at the margin that would not recover the costs associated with earlier increments of the service. In the long term, such pricing is not viable. From the point of view of designing an incremental cost test in a transition to competition, for an industry with significant economies of scale resulting from a long period of franchise monopoly, total service costs are the appropriate measure, since common costs are very large.

7. Stand-Alone Cost

Stand-alone cost is another key cost concept. As the name suggests, it refers to the cost of providing the service on its own, without any other services with which to share costs. Calculation of stand-alone cost is the second step necessary to ensure the prevention of cross-subsidy.

8. Least Cost

The importance of measuring stand-alone cost on a least cost basis must be underscored. In the long term competitive market, all costs are variable and only the least cost technologies survive. Moreover, if least cost technology is not analyzed, then the door is opened to cross-subsidy and economic coercion because extra costs incurred to pursue non-basic services are attributed to basic service.

9. Cost Consistency

All major services should be subject to cost analysis using similar methodologies, and similar capacities or functionalities provided by specific facilities should have similar costs for all services.

B. COST RECOVERY

If cost analysis is done properly, we should have identified the total service long run incremental costs (TSLRIC) associated with any particular service. Prices should cover those costs and make a contribution to the shared costs. Because shared costs will have to be allocated arbitrarily, the purpose of rigorous cost analysis is to diminish as far as possible the category of shared costs. In a network with significant shared costs, such as the integrated telephone/video network contemplated, the task of allocation is large and extremely important.

10. "User Pay" Principle

A key concept in telecommunications pricing is "user pay". All users of the advanced telecommunications network should pay for all functionalities that they use in reasonable proportion to the costs associated with those functionalities. Where there are joint and common costs, over-recovery of revenue (excess profits) cannot be allowed, but this does not negate the fundamental principle that all services should pay for all functionalities they utilize.

11. Subsidy Free Prices

Subsidy-free pricing is the economic efficiency standard that must be met. However, subsidy-free pricing only establishes a range of prices that are reasonable (between TSLRIC and least cost stand-alone cost).

Floor prices (eg: TSLRIC) and ceiling prices (eg: least cost, stand-alone service cost) should be identified to prevent cross-subsidy and to establish the range of acceptable prices.

12. Predictable Price Rules

Within the range of subsidy free prices, specific, predictable price rules (eg: equal mark-ups above direct costs or equal mark-downs below stand-alone cost) should be applied to ensure that competitors are not placed at a disadvantage and that consumers are compensated for the costs of facilities used to provide competitive services.

C. THE ALLOCATION OF SHARED COSTS SHOULD MINIMIZE THE BURDEN ON CAPTIVE RATEPAYERS

Where flexibility in pricing exists, pricing methodologies should minimize prices to captive ratepayers for basic service. Not only does this principle both protects captive ratepayers and promote universal service, as required by the 1996 Act, but it also promotes competition.

1. Congressional Intent

Congressional intent in this regard could not be more clearly stated.

As noted in the previous Section, Congress went well beyond a formal definition of cross-subsidy to state a clear preference for cost allocators when it required "cost allocation rules, accounting safeguards, and guidelines to ensure that services included in the definition of universal service bear no more than a reasonable share of the joint and common costs of facilities used to provide those services."

The Conference Report makes a point of stating that in adopting Section 254(k) the House

is receding to the Senate.[15] The Senate report made it clear that a reasonable share of joint and common costs was the maximum that should be included in the rates for universal service, but that less could be allocated to these services.

> The Commission and the states are required to establish any necessary cost allocation rules, accounting safeguards, and other guidelines to ensure that universal service bears no more than a reasonable share (and may bear less than a reasonable share) of the joint and common costs of facilities used to provide both competitive and noncompetitive services.[16]

2. The Loop As a Common Cost

Above all, we view the loop (the wires that connect the end-user to the network and are used to complete all telephone calls -- local, intralata long distance, and interlata long distance - and to provide enhanced services) as a shared facility. The loop is an input for every service sold in the telecommunications network. If the loop were not provided by the existing local exchange companies, telecommunications service providers would have to build their own loops, or rent the use of some other loop in order to sell their services to the public. Ratepayers do not own the loop and they do not control the incoming calls place on the network by other end-users and service providers.

Because the loop is a joint and common cost shared by competitive and non-competitive services, it is subject to Section 254(k).

3. Other Economic Grounds for Minimizing the Share of Common Costs Allocated to Basic Service

Where there are unallocable common and joint costs in enterprises selling a combination

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[15]Conference Report, p. 34.

[16]Conference Report, p. 29.

of competitive and monopoly services, the contribution from competitive services should be maximized. Because captive ratepayers have no alternatives, regulatory mechanisms must protect them from excessive burdens. Minimizing the burden on ratepayers and maximizing the contribution of competitive services also protects competitors from unfair competition because competitors do not have access to a captive, monopoly core business to absorb costs.

As enterprises become involved in a mixture of monopoly and competitive services, additional risks may be incurred and benefits may be conferred on the monopolist. Regulatory mechanisms to insulate basic service ratepayers from the risk of competitive enterprises must be established. Increases in the cost of capital caused by those enterprises must fall on competitive businesses.

There are a variety of economic advantages gained by the local exchange carrier franchise position. These, too, provide an economic basis for lowering basic access rates. Many of the activities into which the telephone companies would like to move, and have moved, benefit in tangible and intangible ways from the fact that they are extensions of the franchise monopoly. The people who grant the franchise have a right to share in the economic benefits that the monopoly creates. Unregulated subsidiaries should not be allowed to achieve excessive rates of return because they are an extension of the franchise monopoly.

Revenue streams resulting from readily identifiable telephone company monopoly positions should be carried above the line for regulatory purposes. Cost reducing advantages for competitive services that flow from the monopoly franchise (e.g. new subscriber lists) should be recognized by fees paid to monopoly services. The value of intangible benefits (e.g. goodwill) should be estimated and paid for, thereby lowering the cost of monopoly services.

Thus, one can formally attribute fewer costs to the local category or one can attribute greater revenues to it because

- local exchange service places lighter technological demands on the network;
- local service remains a monopoly and therefore does not require the same rate of return as competitive services; and
- the local franchise has created advantages in related lines of business.

D. CONCLUSION

This framework establishes an empirically manageable, balanced approach to pricing. It meets the fundamental economic efficiency criteria -- prevention of cross-subsidy -- without pursuing economic efficiency to extreme, burdensome, and often unachievable ends. With the basic condition of efficiency met, it blends public policy goals of protecting captive ratepayers and promoting competition by preventing economic coercion, which the local exchange companies would accomplish by allocating all of the economies of joint and common production to prevent competition from entering the marketplace.

V.

PRICING ACCESS TO BOTTLENECKS

A. EFFICIENT COMPONENT PRICING (ECP)

The incumbent LEC approach to pricing which allocates all of the benefits of efficiencies to competitive services, is paralleled by the approach to pricing of unbundled elements which the incumbents advocate at the state level. The LECs insist that if mandatory interconnection, unbundling and resale are imposed, the price must restore the full value of the monopoly network. The companies insist that should unbundling and resale occur, it must take place at prices that make them whole (restore all of their revenues as if they were still monopolists). The companies want to be paid the full opportunity cost for all of their assets as if they still were a monopolist. This is unacceptable policy under the 1996 Act.

Ameritech's argument in Ohio illustrate this point of view.

> Long run incremental costing simply looks at avoided costs - the cost of operating with and without the asset. It does not take into account the fair market value or the revenue flows from the most valuable or next best use to which the property can be adapted. In fact it does not even take into account the incurred costs of certain portions of loops and switch port facilities...
>
> Ameritech's foreseeable net income flow is the discounted present value of the service revenue that would be generated from its use of its loops and ports. It is that value which constitutes just compensation to be paid to Ameritech by the Commission for the loops and ports ordered to be provided to competitors...
>
> The fair market value of the property taken must also include the diminution of value of Ameritech's residual property.[17]

The most frequent approach put forward by incumbents is to offer to sell access to the

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[17]Ohio Competition Proceeding, Ameritech, Legal Brief, pp. 23-24.

monopoly facilities that they control at so-called efficient component prices.[18] This rule says that new entrants can choose to not purchase any element they desire and will not be charged the incremental (direct) costs incurred by the incumbent to provide those components. However, the entrants must pay the direct costs for any monopoly components they do buy, plus all shared costs, overheads, and profits that the incumbent loses if the entrant wins a customer (the opportunity cost of losing a sale).

The following Figure describes the situation. Company A has a monopoly on the sale of Z. Z is delivered by combining inputs y and x. The direct costs of x are 3, the direct costs of y are 3 and the shared and overhead costs of x and y are 4. Z is sold at retail for 10.

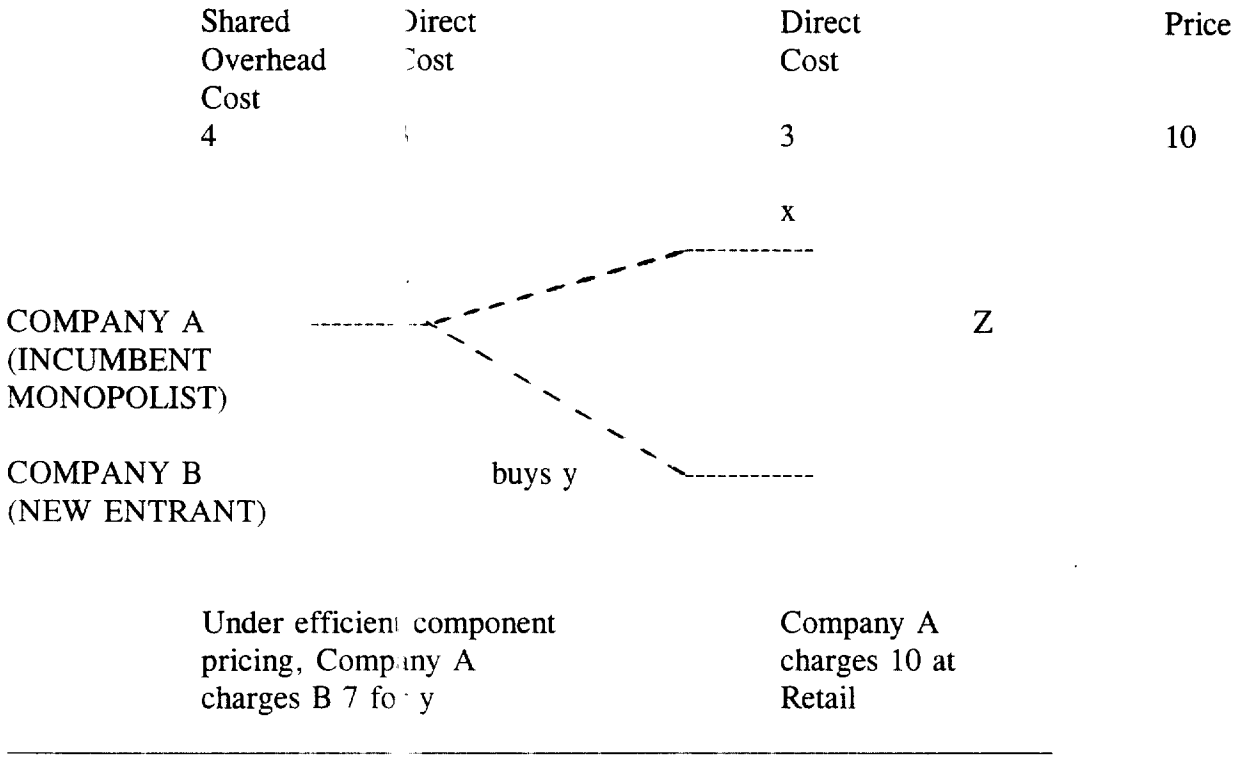
Company B wants to compete for the sale of Z. It can self-supply x, but it needs to buy y. Under efficient component pricing, company A would charge company B 7 for y, recovering both the direct costs of the monopoly component y and all of the shared and overhead costs of both x and y.

B. DIRECT COST OF SUPPLY (DCS)

New entrants in a number of industries, including railroads, electricity, the postal service and telecommunications have criticized this approach as antithetical to the introduction of

[18]See for example, "Prepared, Direct Testimony of Paul W. MacAvoy," before the Illinois Commerce Commission, Petition for a Total Local Exchange Service Wholesale Tariff from Illinois Bell Telephone Company d/b/a Ameritech Illinois and Central Telephone Company Pursuant to Section 13-505.5 of the Illinois Public Utilities Act, September 15, 1995 (hereafter Illinois Wholesale Proceeding).

FIGURE 2:
EFFICIENT COMPONENT PRICING



competition. They argue that access to the network and purchase of monopoly network functionalities should be at the direct cost of supplying those functionalities -- **at** TSLRIC,[19] not just **based on** TSLRIC.

> To ensure appropriate pricing, the rate for wholesale services should be set at the incumbent LEC's forward-looking, direct, economic cost of providing the wholesale service, adjusted as necessary to reflect the LECs' receipt of direct or indirect subsidies assuming other LEC services have not been adjusted to reflect the elimination of subsidies. This method, which would establish a sound pricing base for efficient future competition, requires the performance of a wholesale

[19]Both AT&T and MCI use LRSIC in the Illinois Wholesale Proceeding cited to be interchangeable with TSLRIC. To prevent confusion, we will continue to use TSLRIC.

"bottoms-up" [TSLRIC] study.[20]

The new entrants raise a number of objections to the LEC proposal for pricing that includes a mark-up above TSLRIC.

> With regard to unbundled loops, interconnect and other essential input functions, the proposed rules would require that prices be set at [TSLRIC] plus "contribution to joint and common overhead" costs. Including such "contribution" or mark-ups in the prices for essential input functions will significantly impede the development of competition and ultimately limits its effectiveness.
>
> First, "joint and common overhead costs" are difficult to define, quantify and attribute. LECs will have a clear incentive to "pack" those essential input functions with as much "contribution" as possible...
>
> Second, to the extent that any "joint and common" costs are recovered in essential input functions, those costs will be completely protected from competitive pressures. Unlike the joint and common costs of any competitive firm, the joint and common costs of a LEC that are included in any interconnection rate or other essential facility rate cannot and will not be competed down...
>
> Third, including joint and common costs in any essential input function will reduce the benefits that consumers should ultimately receive from competition...
>
> Fourth, including mark-ups in the essential input functions creates incentive for anti-competitive behavior, as LECs seek to "charge" competitors more of a mark-up than they "charge" themselves.[21]

Based on these and a number of other observations, new entrants have advocated an alternative approach, which can be called the Direct Cost of Supply (DCS). In this approach, the incumbent must price the monopoly inputs only at the direct costs of supply. A would charge B 3 for y. It would recover its shared and overhead costs in the retail price. If B can produce x more efficiently or can save on shared and overhead costs, it would be able to sell

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[20]Illinois Wholesale Proceeding, AT&T Petition, p. 15

[21]Illinois Wholesale Proceeding, "Initial Comments of MCI," pp. 9-10.

at a lower price.

One of the key issues in this debate stems from the nature of shared and overhead costs. By declaring this category of costs to be common costs which are not direct, the incumbent declares in essence that they cannot be attributed. These costs are invariant with respect to the output of y and x. The fact that it supplies only y instead of both x and y can have no bearing on the magnitude of the shared and overhead costs.

If ceasing to sell x would lower the common costs, then those costs are not really common, but should have been identified as direct costs of x. If they can be attributed -- if they change when one of the elements is not supplied -- they are direct costs that have simply been miscategorized.

This gives weight to the argument by entrants that they too will have shared or overhead costs and efficient component pricing places them at an inevitable and immediate disadvantage. It also supports the argument that their ability to reduce these costs results from real efficiencies, not simply supplying part of the input through a regulatory loophole, and therefore represent a positive public policy outcome.

C. EVALUATING THE ALTERNATIVES

1. Efficiency

The theoretical and regulatory literature suggests the following relative characteristics of the alternative proposals.

ECP assumes that the current state of affairs is efficient. Taking all the direct costs for a monopoly element as efficient, and adding all the shared and overhead costs associated with